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SUBCOMMITTEE REPORT  
ON  
THE INCOME TAX  
TO  
THE MARYLAND TAX REVISION  
COMMISSION OF 1939

December 27, 1940

Members of Subcommittee

H. H. Walker Lewis, Chairman

Huntington Cairns

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The recommendations in this report have been tentatively approved by the Commission. Comments and criticisms are requested.



## SUMMARY OF RECOMMENDATIONS

The subcommittee on Income Taxation proposes:

1. That no tax be payable by any person having less taxable income than the amount of his allowable deductions and personal exemptions.
2. That the rate of tax on investment income be reduced from 6% to 5%.
3. That the rate of tax on ordinary income be reduced from 2-1/2% to 2%.
4. That the income tax be made payable in four installments.
5. That the time for filing returns and for paying the first installment be deferred one month.
6. That the above changes be made applicable to the tax on 1940 income, payable in 1941.
7. That various other miscellaneous changes be made in the text of the income tax law.

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# A. RETENTION OF INCOME TAX

The subcommittee has devoted considerable time to a critical analysis of the classified income tax law enacted by Chapter 277 of the Acts of 1939 and its practical operation.

It should be noted at the outset that the Constitutional validity of the tax has been sustained by the Court of Appeals and that the total collections are not far below the estimate of \$8,000,000 made by the Commission which recommended it. According to the latest figures received from the Comptroller the actual collections under the 1939 law through December 17, 1940, have been as follows:

Corporations	\$1,366,477.49
Resident individuals	6,271,724.77
Non-resident individuals	38,787.85
Fiduciaries	84,160.23
Tax withheld at source	<u>8,479.23</u>
	\$7,769,629.57

The Comptroller expects to collect a further \$75,000 from tax deficiencies and through the operation of information returns already filed. It also seems reasonable to assume that additional collections will result from field audits. Furthermore, no check has yet been made against Federal income tax returns and this will probably disclose additional tax liability under the State law.

It is interesting to note that the failure of the present law to produce revenue in excess of the estimates is directly traceable to the repeal of the Federal undistributed profits tax. In preparing the present law reliance was placed upon income data for the year 1937 and the yield



from the tax has equalled or exceeded the estimates in all categories other than dividends. There was, however, a sharp drop in corporate dividends and analysis indicates that the major cause was the repeal of the Federal tax on undistributed corporate profits, this tax having been in effect in 1937 and having forced corporations to distribute an abnormally high proportion of their current earnings.

Doubtless there will be annual variations in the yield of the income tax, but the fact that the Maryland law does not take into account capital gains or losses will exert a stabilizing influence. It is believed that the tax base will be more stable than that of the Federal tax in that it will not be affected by capital gains or losses upon the sale or disposition of securities and other property. This feature of the Maryland Act is highly meritorious.

Since the present Commission is primarily concerned with the problem of revising the existing tax structure so as to eliminate inequalities and improve administration, it is perhaps unnecessary for us to attempt to justify the adoption of an income tax, as compared with other forms of taxation. We may say, however, that on the whole we concur in the statement of the last Commission that this form of tax "if not carried to extremes, is sound in theory, and regardless of the needs of the moment must form a permanent part of the tax structure of the State".

The fact that real estate is now bearing a heavy tax burden and is the chief source of local revenue argues against any increase in ordinary State property taxes; and the fact that a very large part of the State's revenue is raised by special sales taxes (such as the gasoline, titling and liquor taxes) is a factor to be considered. It is generally recognized that sales taxes, especially a general sales tax (such as the Emergency





Gross Receipts Tax adopted by Maryland in 1935 but abandoned in the following year) are "regressive", that is to say exact a larger proportional contribution from persons having small incomes than from those having large incomes.<sup>1</sup>

Our studies have indicated that while many of the States turned to the sales tax during the past decade, the trend is now otherwise. In addition most of the States having a general sales tax have found it necessary to protect the tax against avoidance by also imposing a "use" tax applicable to articles purchased outside the State (of the 24 States now having general sales taxes, 17 also have "use" taxes). A tax on the use of property purchased elsewhere and brought into the State is little different from a tariff and the effect has been to create serious trade barriers between the States. The fact that sales taxes lead to such a result is one of the weighty arguments against such taxes.

More States now have income taxes in one form or another than ever before in our history. Through the device of reciprocal tax credits it has been possible in most cases to avoid multiple taxation of the same income and also to avoid the burden upon interstate commerce incident to sales taxes. The passage of the Public Salaries Tax Act by Congress in 1939, which subjects the salaries of Federal officials and employees to State income taxes, is another factor tending to induce the adoption of State income taxes. Decisions of the Supreme Court which permit the taxation of income derived from foreign trusts and inter-state commerce likewise point in the same direction.

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1. For a discussion of the relative advantages of a general sales tax as compared with an income tax see Note 47 Harv. Law Rev. 860, 870; "General Sales or Turnover Taxation" (Nat. Ind. Conf. Bd. 1929); Shoup, "The Rush Toward a Sales Tax"; (1933) 22 Nat. Mun. Rev. 172; "The Sales Tax in the American States", Haig and Shoup (1934) pp. 100-108.



Some of the criticisms directed at the Maryland Act seem to be based upon the argument that a graduated or progressive tax like that under the Federal law is preferable to the classified form of tax. The theory of the graduated tax seems to be that persons who have a capacity to earn large incomes are peculiarly fitted not only to stand a tax proportionate to the income but in addition an increase in rates. This theory has never been applied to the taxation of property and its soundness has been questioned.<sup>2</sup> There is a danger, also, that the graduated tax may be carried to extremes so that it falls only on a small group of taxpayers. The larger the tax group the more resistance there is to increased taxes and the more insistence there is upon efficiency and economy. Because of the extremes to which the Federal tax has been carried we are inclined to the view that a flat rate classified tax is preferable under existing conditions.

#### B. OBJECTIONS TO PRESENT LAW

The fact that we recommend the retention of a classified income tax does not mean that we believe the present law free from fault. It was prompted by revenue considerations of an emergency nature. In addition it represented a compromise involving on the one hand the repeal of the severe intangibles tax and on the other an effort not to throw the full burden of the revenue loss on the general taxpayers.

The three principal objections made to the 1939 law are:

(1) The fact that the tax is not limited to

net income.

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2. See Bulletin of National Tax Assn., March 1940.



(2) That the personal exemptions specified in the law are not real exemptions as applied to persons having investment income.

(3) That there is too great a disparity between the 6% rate on investment income and the 2-1/2% rate on ordinary income.

A further result of the third of these objections is to cause a serious discrimination against business conducted by ordinary business corporations. Under the present law the owners of an incorporated business may be called upon to pay State income taxes aggregating up to 7-1/2% of net income, whereas the tax would only be 2-1/2% if the same business were conducted by an individual or a partnership.

#### C. EXTENT TO WHICH INCOME TAX REVENUE CAN BE DECREASED

We have been advised that the State budget now in course of preparation contemplates a reduction of approximately \$1,100,000 in the future collections from the individual income tax and our Commission has been requested to recommend changes in the law which will most equitably distribute the benefit of this reduction.

We are submitting recommendations which, if adopted, will result in a net decrease of State revenue from the individual income tax of approximately \$1,125,000. Such recommendations will also result in a decrease of approximately \$375,000 in local revenues, as to which see the later portion of this report headed "H. Revenue Effect of Changes and Local Distribution."



#### D. CHANGE IN BASIS OF INDIVIDUAL INCOME TAX

Although deductions and personal exemptions are allowed in full as to ordinary income they are allowed only in part as to investment income under the present law. This results from the fact that the tax on investment income is computed at 6% whereas credit is given for deductions and personal exemptions on the basis of only 2-1/2%, the tax not actually being computed on net income. The effect is that the personal exemption with respect to a single individual having only investment income is not \$1000 as specified in the law but \$416.67, and that the other personal exemptions are allowed only in the same proportion.

By reason of this method of computation the tax on investment income reaches a large class of persons of relatively slender means, including widows and retired workers who have inherited or acquired a modest competence, many of whom were not taxed under the prior law. This was due principally to the fact that no attempt was ordinarily made to enforce the intangibles tax as to small security holders. Also the present law reaches income from some investments which were not subject to the intangibles tax.

We feel that the law should be amended so as to grant a complete exemption from tax to all persons who do not actually have taxable income in excess of their allowable deductions and personal exemptions. In order to effect this we recommend that the tax on individuals be computed by subtracting deductions and personal exemptions from gross income and then taxing the net income as follows: at the investment rate up to the amount of investment income, and the balance, if any, at the ordinary rate.<sup>3</sup>

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3. Under the present law these rates are 6% and 2-1/2% but a reduction to 5% and 2%, respectively, is proposed in the next subdivision of this report.





The effect of this change, assuming no change in tax rates, may be illustrated as follows:

	<u>(a)</u>	<u>(b)</u>
Investment income	800	1000
Ordinary income	250	600
	<u>1050</u>	<u>1600</u>
Deductions and personal exemption	1050	1100
Net taxable income	<u>0</u>	<u>500</u>
Tax payable under this proposed amendment	None	30.00
Tax under present law	28.00	47.50

For purposes of comparison the above examples are worked out on the basis of the 6% and  $2\frac{1}{2}\%$  rates fixed by the present law. A further reduction in the tax payable in these situations will result if the rates are also lowered as proposed in the next subdivision of this report.

It is obvious that the chief effect of this change is upon persons in the low income groups and it will eliminate all tax as to several thousand persons of small means who are now required to pay a tax. It will not benefit all persons having investment income or even a very large proportion of them and it should not be regarded as a reduction of the tax on investment income as such.

If the above change is made we recommend that it be applied to fiduciaries as well as to individuals. This will remove serious defects, including constitutional questions, now involved in the application of the present law to fiduciaries.

We do not recommend any change in the personal exemptions for which provision is now made in the law as follows:

Single persons	\$1000
Heads of family and married persons.	2000
Dependents	400



The single exemption is now \$200 higher than that allowed under the Federal law, the other two being the same. All three exemptions are at approximately the average in other States having income tax laws.

#### E. REDUCTIONS IN RATES

There is in our opinion too great a spread between the rates of tax on (a) investment income and on (b) ordinary income. The difference was due first, to the fact that the tax on investment income was intended to supersede the old intangibles tax which was a more severe tax, and second, to financial emergency and the necessity of raising substantial new revenue to balance the budget.

These reasons were at best temporary and we feel that present and future changes in the tax should be effected in such a way as to lessen the spread between the rates on these two types of income. To this end we propose that the rate on investment income be reduced from 6% to 5%.

Both the changes proposed above, namely (a) the allowance of full deductions and personal exemptions and (b) the reduction of rate from 6% to 5%, apply to investment income, although the first change benefits only a relatively small proportion of those who will still be required to pay the tax on investment income. It is accordingly proposed that the rate of tax on ordinary income be reduced from 2-1/2% to 2%.

The change of rate on ordinary income will have the further advantage of making the computation of the tax easier from the standpoint of both taxpayers and administrative officials.



Proportionately, the reduction of rate is greater as to ordinary income than as to investment income, being a 20% decrease on ordinary as against 16.7% on investment income. It should, however, be noted that many persons having investment income will also benefit by the proposed change allowing deductions and exemptions in full and we believe that this readjustment in rates will do substantial justice. Should a later change in rates be made we strongly recommend that it be effected in such a way as to decrease rather than increase the spread between the two rates.

No change is recommended in the rate of income tax applicable to corporations, this rate being  $1\frac{1}{2}\%$  under the present law.

#### F. INSTALLMENT PAYMENTS AND DATE OF RETURN

There seems to us no question as to the desirability of permitting the income tax to be paid in installments rather than in one lump sum at the time of filing a return. The only reason for not permitting this under the 1939 law was the insistence of the fiscal officers of the State that under the conditions which then existed the effect of permitting installment payments would be to prolong the necessity of the deficit financing which the tax was intended to eliminate. The reason for lump sum payments has now disappeared and we have no difficulty in recommending that the tax be made payable in four installments.

An unnecessary hardship also results to some taxpayers from the requirement that State income tax returns be filed at the same time as Federal returns. In addition March 15 has become a heavy tax date, payments for motor vehicle licenses and certain personal property taxes being required at approximately that time as well as income tax payments.



In order to relieve this situation we propose that the time for filing returns be deferred one month beyond the date on which they are required under the present law. This will also result in deferring for a month the date on which the first installment payment is due, the other installments to be due on the same date as quarterly payments under the Federal law.

Under this plan an individual reporting on a calendar year basis would not be required to file his return or make his first income tax payment until April 15, rather than on March 15 as now required. Similarly a month leeway will be given persons reporting on a fiscal year basis.

These changes are intended to apply to corporations, partnerships and fiduciaries as well as to individuals.

#### G. EFFECTIVE DATE OF ABOVE CHANGES

It is recommended that all the changes proposed above be included in a separate bill to become effective on the date of its passage. In this way they will apply to the income tax returns for 1940.

Where returns are filed on a fiscal year basis it is contemplated that the above changes will be applicable to fiscal years ending after December 31, 1940.

#### H. REVENUE EFFECT OF CHANGES AND LOCAL DISTRIBUTION

The revenue effect of the changes suggested above will be to reduce the total yield from the tax by approximately \$1,500,000, such being computed on the basis of the returns filed under the 1939 law.





The indications are that income of 1940 has been in excess of that for 1939 on which our calculations are based.

The present tax on investment income replaced the old intangibles tax of which two thirds was retained locally and the remainder paid to the State. Accordingly, when the intangibles tax was abolished it was necessary to compensate the localities for the revenue loss. The method adopted was to allocate one-fourth of the collections from the individual income tax to the localities in which the taxpayers respectively reside, this including a share of the tax on ordinary income as well as on investment income. On this basis \$1,546,713 has been paid to the localities from the individual income tax collections through September 30, 1940, the close of the State's fiscal year. Of this, \$926,990 or approximately 60% was paid to the City of Baltimore and \$619,723 or approximately 40% was paid to the Counties and the cities therein.

A reduction of \$1,500,000 in the total yield from the individual income tax will result in a corresponding reduction of \$375,000 in the amount paid to the localities from this source, of which approximately \$225,000 will be from the share of the City of Baltimore and \$150,000 will be from the share of the Counties and of the cities therein. It is therefore important to consider the effect which the income tax has had upon local revenues as compared with former revenues from the intangibles tax.

Figures as to annual collections from the intangibles tax are not available. For this reason, in determining the yield from the intangibles tax, it is necessary to work from the assessment figures and to assume a 100% collection of the intangibles tax as assessed. Using this method we have computed the amounts received (a) for 1939 and (b) on an average basis for the five year period from 1935 to 1939 inclusive. These



amounts and the amounts received from the income tax by each County (including the cities therein) and by the City of Baltimore are as follows:<sup>4</sup>

COUNTY	Intangibles Tax		Share of 1939 Income Tax
	For 1939	Five Year Average	
Allegany	\$ 20,732	\$ 21,121	\$ 25,805
Anne Arundel	25,675	17,452	29,927
Baltimore	192,196	141,441	190,102
Calvert	540	236	1,393
Caroline	2,328	1,919	2,981
Carroll	6,300	6,406	8,888
Cecil	22,917	15,743	21,569
Charles	1,276	1,153	2,822
Dorchester	7,519	6,325	7,921
Frederick	15,295	11,853	17,873
Garrett	2,263	1,503	2,116
Harford	9,291	7,462	13,345
Howard	9,767	9,967	9,812
Kent	5,247	4,345	4,437
Montgomery	65,169	48,588	155,333
Prince George's	8,275	5,885	38,838
Queen Anne's	26,599	14,631	17,482
St. Mary's	1,681	933	2,934
Somerset	4,011	3,666	2,835
Talbot	13,066	11,444	15,143
Washington	22,766	21,518	32,641
Wicomico	8,814	6,473	12,218
Worcester	4,455	3,833	3,308
Total Counties	\$ 476,182	\$ 363,897	\$ 619,723
Baltimore City	\$ 1,244,286	\$ 1,229,328	\$ 926,990

It is readily apparent that experience in Baltimore City has differed very materially from that in the Counties. It accordingly seems desirable to separately discuss the revenue problems which will result from the proposed decrease in the individual income tax on individuals (a) as to the Counties and (b) as to the City of Baltimore.

4. Assessment figures for the intangibles tax as to the Counties are taken from the annual reports of the Comptroller, and as to the City of Baltimore from the reports of the Bureau of Assessment of Baltimore City.



The Counties.

The Counties as a whole (including the cities therein but excluding Baltimore City) have received substantially more under the income tax than they received under the intangibles tax, even assuming a 100% collection of the intangibles tax, the totals being as follows:

Gain over 1939	\$137,811
Gain over 5-year average	254,524

It is obvious that the actual gain has been substantially greater than this, for two reasons:

First, because the Counties did not ordinarily effect a 100% collection of the intangibles tax as assessed.

Second, because the cost of assessing and collecting the intangibles tax was borne by the Counties, whereas the cost of administering and collecting the income tax is borne by the State.

Accordingly, it is clear that on any basis the Counties, as a group, have gained more through the substitution of the income tax for the intangibles tax than the \$150,000 they will lose through the reductions in rate which we are recommending. As the local distribution of the income tax has been in effect for only one year it is equally clear that the Counties have not yet adjusted their respective budgets to the increase so as to make it financially embarrassing for them to share in the proposed reduction.

In addition the localities have gained a substantial and unexpected amount this year from the change in the method of assessment of tangible personal property of foreign ordinary business corporations. Although formerly locally assessed, such property is now assessed by the State Tax



Commission pursuant to Chapter 387 of the Laws of 1939. Data is not available as to the increase in local taxes resulting from this change, the taxes still being payable locally, but the indications are that the Counties will gain far more in added revenue from this source than they would lose by the proposed reductions in the individual income tax. In addition the cost of assessing such property is now borne by the State rather than by the localities as formerly.

Of course, it must be recognized that the situation varies from County to County and that some Counties have lost while most of them have gained. The effect of the proposed reduction on each individual County is, however, so relatively small that it seems fair to assume that the Counties should and will be willing to share in the reduction, particularly if the City of Baltimore does likewise.

It is important to note in this connection that the entire benefit of the reductions will go to individuals residing in the particular localities affected. Furthermore, the local government loses only one-fourth of the amount saved to its citizens, the other three-fourths being absorbed by the State. For example, Howard County will lose revenue only because its own citizens will pay less income tax and for every dollar that the County government loses its residents will save four.

City of Baltimore.

In view of the magnitude of the City of Baltimore problem it seems desirable to consider its experience with the intangibles tax for each of the five years from 1935 through 1939. Assuming a 100% collection of the tax as assessed (which in the case of the City gives an approximately





correct result) the City's share of the intangibles tax was as follows:<sup>5</sup>

1935	\$1,088,386
1936	1,085,075
1937	1,263,615
1938	1,465,280
1939	1,244,286
5 year average	\$1,229,328

As against this the City's share of collections from the income tax through September 30, 1940 was \$926,990, or \$317,296 less than the intangibles tax for 1939 and \$302,338 less than the five year average.

It will be noted that the peak under the intangibles tax was reached in 1938 and that it took a severe drop in 1939. It is our belief that a further drop would have been experienced for the year 1940 if the intangibles tax had been continued, for which reason the actual revenue loss sustained by the City of Baltimore through the abolition of the intangibles tax and the substitution of the income tax is probably not as great as indicated by the above figures.

A further fact is important. Although two-thirds of the intangibles tax was retained locally, one-third went to the State. The fact that the City was collecting such a disproportionately large amount on the intangibles tax, as compared with the Counties, can mean only one thing, that the residents of the City of Baltimore were paying far more than their share of the intangibles tax received by the State. The readjustment of the tax burden in this respect may have resulted in a tax loss to the City of Baltimore but it has also resulted in a considerable and obvious benefit to its citizens.

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5. The assessment figures are taken from the annual reports of the Bureau of Assessment of Baltimore City. Reports covering collections from the tax are also published by the Bureau of Receipts, but these do not segregate by year the amounts representing arrearage collections for prior years and it is not therefore possible to determine the collections properly attributable to any particular year.



The reduction in the individual income tax as proposed in this report will result in a further loss of revenue to the City of Baltimore of approximately \$225,000 in addition to the loss already sustained by the City. However, other recommendations already made or to be made by the Commission will result in increased revenue to the City of Baltimore in excess of \$300,000 a year, the changes which we have in mind being as follows:

(a) Reinstatement of tax on intangibles owned by the B. & O. Railroad as recommended in the subcommittee report on Corporation Taxation dated October 7, 1940.

(b) Allocation to City of Present State licenses on auctioneers, junk dealers and pawnbrokers as recommended in the subcommittee report on License Taxation dated November 12, 1940.<sup>6</sup>

(c) Share of fines and forfeitures collected in City and now payable to State.<sup>7</sup>

(d) Share of tax on building and loan associations and credit unions as recommended in the subcommittee report on this subject dated December 27, 1940.<sup>8</sup>

In addition the City will benefit from the central assessment by the State of the tangible personal property of foreign ordinary business corporations. The benefit to the City from this change will not be as

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6. Auctioneers' licenses in the Counties are retained locally whereas that in the City of Baltimore is payable to the State, and it is planned to allocate collections from this license to the City. The repeal of the State licenses on junk dealers and pawnbrokers will make it possible for the City to take over these sources of revenue as well.

7. At the present time half of the fines and forfeitures collected in the City of Baltimore are payable to the State whereas such amounts collected in most of the Counties are retained locally. It is planned to place the City and all Counties on the same basis in this respect.

8. The proposal is to tax such organizations in the same manner as savings banks are now taxed. Under the present law three-fourths of this tax will go to the locality.



great proportionately as that to the Counties, due to the fact that the assessment methods of the City of Baltimore were on the whole better than those of the Counties. Preliminary data indicates, however, that the City will derive a revenue gain from this source, as well as being relieved of the expense of making the assessments, this work now being done by the State.

The effect of the above will be to restore to the City of Baltimore the amount which it has heretofore lost through the abolition of the intangibles tax, thus placing it in more or less the same position as the Counties, which gained rather than lost through the change. If restoration is made to this extent it seems fair to expect the City to share with the Counties and with the State in the proposed reduction in the income tax, especially as whatever the City loses will go directly into the pockets of its own citizens and taxpayers. In fact for each dollar the City loses its residents will gain four dollars in reduced income taxes as they will save the State's as well as the City's share of the tax.

In the event that the localities absorb their proportionate share of the revenue loss from the proposed reductions of rate in the individual income tax, the loss to the State will be approximately \$1,125,000. We have been advised that the State cannot afford to give up more than this amount of revenue from this source if the change is to be effective as to the tax payable on 1940 income. We believe that the change should be made effective as to such income and we therefore hope that the localities will facilitate it by sharing in the reduction to the extent of their one-fourth interest in the tax.



# I. MISCELLANEOUS CHANGES

In addition to the above, various miscellaneous changes should be made in the text of the income tax law to meet situations which have developed in its administration. These will be described in the final report of the Commission but in the interests of brevity are omitted at this time.

